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No. 670

In the Supreme Court of the United States

October Term, 1962

NATHAN HAUPTMAN, TRUSTEE, PETITIONER

v.

DIRECTOR OF INTERNAL REVENUE, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENTS IN OPPOSITION

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No. 670

NATHAN HAUPTMAN, TRUSTEE, PETITIONER

v.

DIRECTOR OF INTERNAL REVENUE, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENTS IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. 18) is reported at 309 F. 2d 62. The opinions of the bankruptcy referee (R. 12a–20a)[1] and of the district court (Pet. 16–17), are not officially reported.

JURISDICTION

The judgment of the court of appeals was entered on September 18, 1962. (Pet. 24.) The petition for a writ of certiorari was filed on December 17, 1962. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

[1] "R." refers to the appendix to the appellant's brief in the court of appeals.

QUESTION PRESENTED

Whether the taxpayer-corporation's election to be taxed as a small busines. orporation, in accordance with Subchapter S of ıe Internal Revenue Code of 1954, was valid and effective.

STATUTES INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 172. NET OPERATING LOSS DEDUCTION.

* * * * *

(h) [as added by Sec. 64(b), Technical Amendments Act of 1958, P.L. 85–866, 72 Stat. 1606] DISALLOWANCE OF NET OPERATING LOSS OF ELECTING SMALL BUSINESS CORPORATIONS.—In determining the amount of the net operating loss deduction under subsection (a) of any corporation, there shall be disregarded the net operating loss of such corporation for any taxable year for which such corporation is an electing small business corporation under subchapter S.

* * * * *

SUBCHAPTER S [as added by Sec. 64(a), Technical Amendments Act of 1958, *supra*]—ELECTION OF CERTAIN SMALL BUSINESS CORPORATIONS AS TO TAXABLE STATUS

* * * * *

SEC. 1372. ELECTION BY SMALL BUSINESS CORPORATION.

* * * * *

(c) WHERE AND HOW MADE.—

* * * * *

(2) TAXABLE YEARS BEGINNING BEFORE DATE OF ENACTMENT.—An election may be made under

subsection (a) by a small business corporation for its first taxable year which begins after December 31, 1957, and on or before the date of the enactment of this subchapter, and ends after such date at any time—

(A) within the 90-day period beginning on the day after the date of the enactment of this subchapter, or

(B) if its taxable year ends within such 90-day period, before the close of such taxable year.

* * * * * *

SEC. 1374. CORPORATION NET OPERATING LOSS ALLOWED TO SHAREHOLDERS.

(a) GENERAL RULE.—A net operating loss of an electing small business corporation for any taxable year shall be allowed as a deduction from gross income of the shareholders of such corporation in the manner and to the extent set forth in this section.

* * * * * *

STATEMENT

For the taxable years 1955 and 1956 the Novo-Plas Manufacturing Company, Inc., reported and paid income taxes on taxable income in the approximate sum of $29,000. In 1957 the corporation suffered a net operating loss of $10,424.93. The corporation allegedly suffered a net operating loss of $184,535.70 for the year 1958. (Pet. 2, 18.)

Subchapter S (Sections 1371–1377) of the Internal Revenue Code of 1954, added to the Code by the Technical Amendments Act of 1958, permits qualifying small business corporations to elect to be treated for

tax purposes in a manner similar to partnerships or sole proprietorships, with the corporation not being treated as a taxable entity and with the stockholders directly reporting, on their individual returns, their aliquot shares of the corporation's net income or operating loss. Novo-Plas qualified as a small business corporation and on November 29, 1958—within 90 days of the adoption of Subchapter S—made a timely election to have those provisions apply for the calendar year 1958 and subsequent years. Pursuant to that election, the sole stockholder of the corporation (Raymond Zurawin) has filed a claim for refund utilizing the corporation's 1958 operating loss as a basis for a refund of individual income taxes paid by him, which claim for refund remains pending.

On January 23, 1959, Novo-Plas made an assignment of its assets for the benefit of creditors which was duly filed under New York law. On February 16, 1959, an involuntary petition in bankruptcy was filed against the corporation, and on March 23, 1959, it was adjudged a bankrupt. (Pet. 18.) The District Director of Internal Revenue has filed a claim in the bankruptcy proceeding for $7,155.61 in employment, social security, and withholding taxes unpaid and due for the years 1958 and 1959.

On September 2, 1959, petitioner, the trustee in bankruptcy, filed a claim for refund of corporation income taxes paid for 1955 and 1956 based upon a carryback to those years of the corporation's 1958 operating loss.[2]

[2] A claim based on the carryback of the 1957 loss was also filed, but that is admittedly allowable and is not in issue.

Asserting that claim as an offset against the Director's claim in the bankruptcy proceedings, the trustee moved the referee in bankruptcy for an order requiring the Director to recognize the trustee as the party entitled to utilize the corporation's 1958 operating loss and restraining the stockholder from utilizing the loss as a basis for refund of his individual income taxes. The referee held that, inasmuch as the corporation satisfied the requirements of Subchapter S and had made a timely election, the stockholder was entitled to report the operating loss on his individual return and, hence, it was unavailable for use as a carryback deduction by the corporation (R. 12a–20a). The district court affirmed the referee's order (Pet. 16–17) and was in turn affirmed by the court of appeals (Pet. 18–23).

ARGUMENT

1. The decision of the court below is correct, there is no conflict and no question of importance requiring review by this Court. The trustee argues, in effect, that the corporation should be allowed to carry back to prior years the alleged net operating loss for 1958 because the net operating loss is a "tax credit" belonging to the bankrupt corporation. (Pet. 8, 9.) But the statute allowing the net operating loss specifically provides, in unqualified terms, that a corporation is denied the benefits of such operating loss in any year in which a corporation is an electing small business corporation under Subchapter S. Section 172(h) *supra*, p. 2. And there is no dispute that Novo-Plas Manufacturing Company, Inc., was such a corporation.

It is the contention of the trustee that the provisions of Section 1374, which pass the corporate net operating loss through to the shareholders, do not apply when the corporation makes an otherwise valid Subchapter S election at a time when the corporation is insolvent or liquidation is contemplated. The trustee is thereby attempting to engraft a restriction upon the provisions of Subchapter S which was not provided nor intended by Congress. The essence of the trustee's argument is that the provisions of Subchapter S were enacted solely to benefit going, operating corporations and that Congress only intended to give the benefits of Subchapter S to corporations intending to continue in business. Section 1374 of the Internal Revenue Code of 1954, however, invites shareholders of small business corporations to avail themselves of the tax advantage derived from using their corporation's net operating losses as deductions on their personal income tax returns. As the court below pointed out (Pet. 22):

> * * *. It is common knowledge that corporate operating losses often lead to corporate liquidation. Therefore, the likelihood that an otherwise qualifying corporation may be liquidated is not a factor that should be considered in order to justify a judicial restriction upon the right to elect the tax treatment Congress granted by Subchapter S.

2. *Pepper* v. *Litton*, 308 U.S. 295, much relied upon by the trustee (Pet. 12–14), is not in point. No such statutory direction as is here contained was there present. Here a statute expressly prevents an electing small business corporation from obtaining the ben-

efits of a net operating loss and the statutory language authorizing the deduction does not contain the limitation upon the shareholders' power to cause a corporation to elect which taxpayer seeks to engraft upon it. In any event, in this proceeding the bankruptcy court has no summary jurisdiction over the shareholder or any right which the shareholder may have received by virtue of the Subchapter S election. See *Cline* v. *Kaplan,* 323 U.S. 97; *Harrison* v. *Chamberlin,* 271 U.S. 191; *Thompson* v. *Dachner,* 214 F. 2d 922 (C.A. 9th); *Ford* v. *Magee,* 160 F. 2d 457 (C.A. 2d); *In re Meiselman,* 105 F. 2d 995 (C.A. 2d). In the last analysis, the question whether the election can be made to the detriment of corporate creditors is in reality a controversy over the fiduciary responsibility of the corporate officers and shareholders. Whether or not such issues are substantial, they are not properly before this Court, but rather must wait the institution of a plenary action by the trustee against the shareholder.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

ARCHIBALD COX,
Solicitor General.
LOUIS F. OBERDORFER,
Assistant Attorney General.
I. HENRY KUTZ,
DONALD P. HORWITZ,
Attorneys.

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